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Before the
Federal Communications Commission
Washington, D.C. 20554

FCC 92-537

In the Matter of	)	
	)	
Simplification of the	)	CC Docket No. 92-296
Depreciation Prescription	)	
Process	)	

NOTICE OF PROPOSED RULEMAKING

Adopted: December 10, 1992; **Released:** December 29, 1992

Comment Date: March 10, 1993
Reply Comment Date: April 13, 1993

By the Commission: Commissioner Duggan concurring and issuing a statement.

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I. INTRODUCTION

1. In this Notice of Proposed Rulemaking (Notice), we continue our efforts to reduce unnecessary regulatory burdens and their associated costs by undertaking simplification of our depreciation prescription process. Under our current depreciation prescription process, we prescribe depreciation rates by plant account for individual carriers.[1] In this Notice, we seek comment on proposals that would simplify procedures and reduce associated costs in our depreciation prescription process.

II. BACKGROUND

A. The Depreciation Process

2. Depreciation is the process of allocating the cost of plant over its service life. Section 220(b) of the Communications Act of 1934, as amended, states that:

> [t]he Commission shall, as soon as practicable, prescribe ... the classes of property for which depreciation charges may be properly included under operating expenses, and the percentages of depreciation which shall be charged with respect to each of such classes of property.[2]

Pursuant to this statutory mandate, the Commission prescribes depreciation

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[1] See 47 U.S.C. §220(b), 47 C.F.R. § 43.43. We generally prescribe depreciation rates on a triennial basis. This results in our review of approximately one-third of the carriers for whom we prescribe depreciation rates each year.

[2] 47 U.S.C. § 220(b).

rates for American Telephone and Telegraph (AT&T), Alascom Inc. (Alascom), and 33 local exchange carriers (LECs) representing 86% of the LEC industry, based on operating revenues.

3. This Commission determines depreciation rates by using the following formula:

$$\text{depreciation rate} = \frac{100\% - \text{accumulated depreciation}\%\text{[3]} - \text{future net salvage}\%}{\text{average remaining life}}.$$

This formula contains two parameters which must be estimated: future net salvage (FNS) and average remaining life (ARL).

4. The FNS is the estimated gross salvage of plant less any estimated cost of removal.[4] The ARL is an average of the future life expectancy of investment in a particular plant account. The ARL is composed of two basic factors: a projection life and a survivor curve. The projection life is the life expectancy of new additions to plant. Considerations for determining the projection life are past life indications of plant in the particular account and the forecast for future conditions and company plans. The survivor curve is the expected retirement distribution (or survival distribution) of plant in an account over time. These two basic factors are then used to develop the future life expectancy of the investment at each age (or vintage) in that plant account,[5] and a composite of these expected lives result in an average remaining life or ARL.

5. Once the parameters are determined, a depreciation rate is computed. The carriers then apply the depreciation rate to the average plant account balance to calculate the depreciation expense for that account. The ultimate purpose of continually estimating depreciation rates is to develop rates, using the most current information, that most accurately allocate plant costs to expense at a rate representative of the actual consumption of the plant.

6. Because the basic factors composing the ARL, projection life and survivor

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[3] Accumulated depreciation is the amount of plant investment that has been depreciated for a particular plant account. In theory, upon retirement of plant, the accumulated depreciation will be equal to the cost of the plant less any net salvage. The purpose of using the accumulated depreciation component in the formula is to correct for any over or under depreciation accruals resulting from over or under prior life and salvage estimates.

[4] Gross salvage is the amount a carrier receives from disposing of retired plant. Cost of removal is the cost the carrier incurs in retiring plant through the removal and disposition of the plant.

[5] Instead of attempting to determine a future life expectancy for every asset in the account, we group assets by age, also known as a vintage group. We may further refine this grouping by subdividing the assets of the same vintage into equal life groups. This recognizes that assets placed into service in the same year do not necessarily have the same lives.

curve, as well as the FNS, are estimates, they are the subject of detailed analyses. Carriers submit detailed studies to prove the merit of their estimates, as required by our rules.[6] A typical carrier submits studies totalling approximately 600 pages and averaging 20-25 pages of analysis per account. It is this part of the depreciation process we seek to simplify in this Notice.

B. Need for Simplification

7. Our current process for determining depreciation rates was born during the 1940's when there was no competition and little technological change in the telephone market. This process was refined over a period in which the Commission regulated telephone earnings on a rate of return/rate base basis.[7] A keen regulatory eye was necessary to ensure "reasonable charges" to ratepayers.

8. However, since this depreciation prescription process was put into place, the telecommunications industry has experienced considerable change. We now have significant competition in the interexchange market, emerging competition in the local exchange market, and more rapidly changing technology. We have recognized these changes, and have put in place a price cap regulatory plan designed to provide the incentives that occur in a competitive market. Our price cap plan encourages carrier efficiency without allowing them to pass depreciation expense changes onto ratepayers.[8] Thus, the scrutiny necessary under rate of return/rate base regulation may be relaxed under price cap regulation. At the same time, the telephone industry has estimated that the annual cost of determining the depreciation rates range from $35-$50 million industry-wide.[9] In light of market and regulatory changes and the alleged high costs of depreciation analysis, we begin this rulemaking to determine whether our detailed prescription process is necessary. We remain cognizant, however, that any streamlined procedures we adopt must be consistent with the Commission's statutory mandate to prescribe "the percentages of depreciation" carriers may charge to operating expenses.

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[6] 47 C.F.R. § 43.43.

[7] Under rate of return/rate base regulation, carriers are allowed to pass on their operating expenses to ratepayers; higher depreciation rates lead to higher depreciation expenses and thus to higher prices.

[8] We note that because price cap carriers would generally not be able to pass along depreciation expense changes, higher depreciation expense can lead to lower earnings for those carriers.

[9] The industry has stated these estimates in a letter to the Office of Domestic Policy and the Council on Competitiveness, Office of the Vice President, dated January 24, 1992 ($50 million estimated), and in a submission to the Commission staff from the United States Telephone Association Ad Hoc Capital Recovery Task Group ($35 million estimated).

III. DISCUSSION

9. In this Notice, we propose four options for simplifying the determination of depreciation expense: the basic factor range option, the range of rates option, the depreciation schedule option, and the price cap carrier option. The first proposal, the basic factor range option, would simplify the depreciation process by establishing ranges for the basic factors that determine the parameters used in the depreciation rate formula; the FNS, and the projection life and survivor curve (the basic factors that determine the ARL). This would eliminate the need for carriers to submit detailed studies in support of their proposed factors. Under this proposal, we would continue to prescribe depreciation rates using the current depreciation rate formula. Carriers would then apply the rates to their plant account balances to determine their depreciation expense.

10. The second proposal, the range of rates option, would simplify the depreciation process by establishing ranges for depreciation rates. Under this option, we would no longer focus on the basic factors used to derive the parameters for the depreciation rate formula, and more importantly, we would not use the depreciation rate formula to derive depreciation rates. However, carriers would continue to apply depreciation rates to their plant account balances to determine their depreciation expense.

11. The third proposal, the depreciation schedule option, would simplify the depreciation process by establishing a depreciation schedule for each plant account. Essentially, the schedule would be based upon a Commission-specified service life, retirement pattern, and salvage value for a particular account. Carriers would then apply the schedule to their investment by vintage.

12. The final proposal would affect only price cap carriers. The price cap carrier option would simplify the depreciation process by allowing price cap carriers to file depreciation rates with no supporting data, but continuing Commission prescription of depreciation rates. Price cap carriers would file their proposed depreciation rates, and the Commission would issue a Public Notice seeking comment on the proposed rates. The Commission would then prescribe depreciation rates based on the price cap carriers' proposals and the comments submitted thereon.

A. The Basic Factors Range Option

13. Using ranges for basic factors would allow the carriers to select their FNS, projection life, and survivor curve for each applicable account from within an established range. These basic factors would then be used to derive the parameters that determine the depreciation rate. Carriers would apply those rates to the applicable account balances to calculate their depreciation expense. This range option would simplify the current process because carriers would no longer be required to submit the detailed analyses to support their proposed projection lives, survivor curves, and FNS values. Eliminating

these submissions should therefore produce an administrative costs saving.[10] This approach also would provide carriers with a greater degree of flexibility than they have experienced under past regulation of depreciation; they would be allowed to select basic factors from within the range while they previously were tied to one set of basic factors. We seek comment on this option.

1. Implementing the Basic Factor Range Option

14. We seek comment on the approach we should take initially to establish the basic factor ranges. We tentatively conclude that industry-wide data should serve as the initial basis for determining the ranges. We also tentatively conclude that ranges should be determined from a statistical analysis of basic factors underlying currently-prescribed rates. For example, we might review the industry-wide data on Motor Vehicles, Account 2112.[11] In establishing the range for the projection life for Motor Vehicles, we might calculate an average of the industry-wide projection lives underlying the prescribed rates for that account and then allow a range of one standard deviation below the average to one standard deviation above the average. We invite comments on this proposal and other alternatives. In discussing range proposals, commenters should address the appropriate width of a range. Commenters should also quantify the administrative costs savings resulting from this simplification approach.

15. We note that we prescribe depreciation rates for thirty-three LECs and two interexchange carriers (IXCs), AT&T and Alascom. We tentatively conclude that we should establish basic factor ranges for each group based upon their respective industry-wide data. We believe that the underlying considerations that go into estimating the basic factors are sufficiently different for the two groups that they should be considered separately.[12] We seek comment on this proposal.

16. We ask whether we should establish basic factor ranges for all plant accounts. We tentatively conclude that, at this stage of the proceeding, we should not. A number of plant accounts are not easily adaptable to ranges because their basic factors widely diverge from company to company and from prescription to prescription. Although we recognize that initially applying

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[10] We note, however, that this option would not eliminate the need for carriers to analyze underlying depreciation factors to determine the reasonableness of their depreciation expense. In fact, with a diminished Commission role in determining depreciation expense levels, we believe greater responsibility will be placed on the carriers and their independent auditors to impose the internal controls and review procedures that are necessary to ensure that reported depreciation expense is reasonable.

[11] 47 C.F.R. § 32.2112

[12] For example, the life characteristics for account 2212, Digital electronic switching, 47 C.F.R. §32.2212, would differ between the two groups; AT&T's digital switches are large, older toll switches, whereas the LECs' digital switches are predominantly newer local switches.

the range option to all accounts for which we prescribe depreciation rates would result in greater simplification and greater administrative costs savings, we believe that we should gain some experience with the use of ranges before we establish them for all accounts. This measured step should yield sufficient information to allow us to later expand the use of ranges to other, perhaps all, accounts. We seek comment on this proposal. We also invite comment on criteria we should use to select the initial basic factor range accounts. Commenters should specifically list those accounts that would meet their proposed criteria.

17. Once accounts are selected and ranges are established for those accounts, we face the issue of whether we should make basic factor ranges mandatory for all carriers for all applicable accounts, or make the approach optional for all or some of the accounts. We tentatively conclude that this option should be mandatory for all carriers for all applicable accounts. We believe that this range option we propose would provide sufficient flexibility for carriers so that mandatory participation would be reasonable. We seek comment on this tentative conclusion. Commenters advocating use of an optional plan should explain how their approach would affect administrative costs savings that would result from mandatory participation.

18. If we mandate use of basic factor ranges, we seek comment on what action we should take for those carriers whose basic factors underlying their currently-prescribed depreciation rates do not fall within the ranges we select. We ask commenters to address whether we should move those carriers into the ranges initially, or phase them into the ranges over time. In addressing the phasing-in approach, commenters should propose a phase-in time table. We also invite comment on the appropriate standard for waiving the use of the basic factor ranges in those few instances when phasing-in may not be appropriate. We tentatively conclude that, because the basic factor ranges approach provides carriers with great flexibility, carriers should be required to show a significant divergence between their expected depreciation expense and that resulting from the use of ranges before a waiver is granted. We seek comment on this standard and alternatives.

19. Implementation also raises the issue of when to implement the ranges: should they be implemented for all carriers at one time or on a staggered basis. While a one-time conversion to basic factor ranges would be expedient, we question whether converting 35 carriers to a new depreciation process at once will produce such an administrative burden for carriers and regulators alike that we should mandate implementation of ranges on a staggered basis. One option would be to implement their use over a three year period, mandating use at the time a carrier is scheduled for its normal depreciation prescription. We seek comment on this issue.

20. Finally, we ask whether a carrier should be allowed to select any basic factor from within the established range, and how often that carrier should be allowed to change any selected basic factor within the range.[13]

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[13] We note, however, that the Commission, under § 220(b) of the Communications Act, maintains final prescription authority.

While we tentatively conclude that the ranges should afford carriers flexibility, they should not provide unreasonable incentives for carriers to make depreciation decisions on the basis of their effect on earnings.[14] Thus, we propose to allow carriers to select their initial basic factors on the basis of the basic factors underlying currently-prescribed depreciation rates plus a specified percentage of change.[15] We would also apply this proposal to any basic factor changes over time. We invite comment on these proposals. As for how often a carrier would be allowed to change its selected basic factors, we tentatively conclude that changes should occur, at most, on an annual basis. We invite comment on this tentative conclusion. We specifically ask commenters to address whether allowing basic factor changes within the established ranges prior to a scheduled depreciation review negates the administrative savings we seek by this simplification option. We also seek comment on whether basic factor changes within the range should be made consistent with our annual update process carriers may now use.[16]

2. Reviewing Established Ranges

21. Under our current depreciation process, we revisit each carriers' depreciation rates every three years. We have found that we must review these rates because the underlying basic factors, the projection life, survivor curve, and FNS, change over time. The changes are attributable to technological advances, customer demand changes, and competitive forces. We expect these changes to continue, and are therefore certain that we will need to revisit the basic factor ranges we may establish. However, we believe that the use of ranges will reduce the need to review basic factors from once every three years to, perhaps, once every five to ten years. We invite comment on this issue.

22. We also seek comment on what procedures and methods we should use to update the ranges established. We could complete a depreciation review on an industry-wide basis. This would require carriers to analyze accounting data and company plans as they now do, and to submit such analysis to us for

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[14] Again, we note that each carrier should continue to analyze the information necessary to determine the depreciation expense appropriate for that carrier.

[15] For example, we might establish a projection life range of 5-10 years for a specific account, and the percentage of change allowed might be 10%. If a carrier's projection life for that account was at 10, that carrier could select a projection life between 9 and 10 years.

[16] For further explanation of the annual update process, see The Prescription of Revised Percentages of Depreciation pursuant to Section 220(b) of the Communications Act of 1934, as amended, for: American Telephone and Telegraph Company - Long Lines Department, et al., Order, 96 FCC 2d 257, 268 at paras. 32-34 (1983).

establishing any new ranges.[17] We could further simplify this reviewing process by either reviewing data at the regional operating company level or by using a sampling method. We invite comment on these options and other alternatives. Commenters should specifically quantify the costs savings attributable to reviewing data on an aggregated level or by sampling.

3. Related Issues

a. Price Cap Treatment

23. Under price cap regulation, a depreciation expense change is treated as an endogenous cost.[18] That is, price cap rates do not change when depreciation expense changes, even if that change results from Commission-prescribed depreciation rates. The endogenous treatment is based on the carriers' control over their own construction plans;

> [w]hile we determine the rate of depreciation, we do not decide for carriers when to deploy new plant and when to retire old ... Accordingly, it is not this Commission, but the carrier, through its decisions on when to deploy and retire equipment, that primarily controls, the rate at which the plant investment is translated into depreciation expense.[19]

24. The basic factor range option would not affect the endogenous treatment of depreciation expense changes. Carriers would continue to have control over their depreciation rates and expenses under this option because, initially, the ranges would be determined from the basic factors underlying currently-prescribed depreciation rates. As noted above, these basic factors give great weight to the companies' future plant investment. Moreover, our proposals for future updating of the ranges also rely on analysis of actual plant retirement, allowing the ranges to reflect industry practice. We therefore tentatively conclude that carriers will control the ranges to approximately the same extent that they control the rate-setting process today, and that they further exercise control over the basic factors they select within the range, and thus depreciation rates.

b. Continued Use of Equal Life Group Procedures

25. The depreciation rates this Commission prescribes are based on a process that allocates the depreciation expense on a straight-line basis over

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17 We note that carriers would be required to maintain their continuing property records regardless of the reviewing process we ultimately adopt. Continuing property records, records of the companies' plant investment, are necessary for accurate accounting records.

18 <u>See</u> Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786, 6809 at paras. 182-187 (1990) (<u>LEC Price Cap Order</u>).

19 <u>Id</u>. at para. 182.

the service life of plant. As we have previously explained,[20] in most accounts, we group assets by vintage and then by life expectancy within that vintage to determine the proper allocation of plant investment over the plant life. This grouping procedure is known as Equal Life Group (ELG). Assuming the estimated basic factors are accurate, this procedure allows the recovery of depreciation expense faster, but at a more accurate, straight-line rate than would result by merely grouping assets by vintage. The accuracy of the survivor curve is extremely important because ELG rates are very sensitive to the shape of that curve. Because ELG allows for faster, albeit more accurate, depreciation than prior methods used, the Commission has allowed the use of ELG rates only when the data necessary to determine the curve shape is available for a specific account of an individual carrier.[21] Since we propose to use industry-wide data to determine a range of curve shapes for accounts instead of account-specific data for individual carriers, we seek comment on whether this should affect our continued use of ELG.

B. The Depreciation Rate Range Option

26. Under this simplification option, the Commission would establish a range of depreciation rates for each applicable account. A carrier would continue to apply the rate to the plant account balance to calculate its depreciation expense. The primary difference between this option and the basic factor range option is that depreciation rates would be established without resorting to the formula we now use to determine depreciation rates. Thus, there might be some additional administrative costs savings. Also, by establishing rate ranges, carriers would have a degree of flexibility they have never had under our depreciation regulation. We seek comment on this option. We ask commenters to quantify the administrative costs savings from adoption of this approach.

1. Implementing the Depreciation Rate Range Option

27. We seek comment on how we should initially establish the ranges of depreciation rates. We tentatively conclude that industry-wide rate data should be the initial basis for determining rate ranges. We also tentatively conclude that ranges should be determined from a statistical analysis of currently-prescribed rates. For example, we might review the industry-wide data on Motor Vehicles, Account 2112.[22] In establishing the range, we might average the prescribed rates for that account and then allow a range of one standard deviation below the average to one standard deviation above the

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[20] <u>See</u> <u>supra</u> n. 5.

[21] <u>See</u> Amendment of Part 31 (Uniform System of Accounts for Class A and Class B Telephone Companies) so as to Permit Depreciable Property to be Placed in Groups Comprised of Units with Expected Equal Life for Depreciation under the Straight-Line Method, <u>Report and Order</u>, 83 FCC 2d 267, 283 at para. 57 (1980) (<u>ELG Depreciation Order</u>), <u>recon.</u>, 87 FCC 2d 916 (1981), <u>supplemental opinion</u>, 87 FCC 2d 1112 (1981).

[22] 47 C.F.R. § 32.2112

average. We invite comment on this conclusion, and request that commenters specifically address the appropriate width of these ranges.

28. This option raises many of the same issues outlined in our proposed basic factor range option. Thus, we set out below, the issues commenters should address:

a. Should we establish two sets of ranges: one for LECs and one for IXCs? We tentatively conclude that we should. <u>See</u> <u>supra</u> para. 15.

b. Should we establish rate ranges for all plant accounts? If not, what criteria should be used to select plant accounts for which we will set initial rate ranges? We tentatively conclude that we should not establish rate ranges for all plant accounts at this time. <u>See</u> <u>supra</u> para. 16.

c. Should we mandate the use of ranges for all applicable accounts and for all carriers? We tentatively conclude we should. <u>See</u> <u>supra</u> para. 17. Commenters should also address what action the Commission should take for those carriers whose current depreciation rates would fall outside the established ranges, as well as an appropriate waiver standard. <u>See</u> <u>supra</u> para. 18.

d. Should we implement ranges for all carriers at the same time? <u>See</u> <u>supra</u> para. 19.

e. Should we allow carriers to select any rate from within the established range?[23] How often should we allow carriers to change their rate within the range over time? We ask commenters to specifically address whether carriers should be allowed to change a depreciation rate by a specified percentage on an annual basis. <u>See</u> <u>supra</u> para. 20.

Commenters should specifically address the administrative costs savings associated with the use of a range of depreciation rates when appropriate. Commenters may offer their own proposals.

2. Reviewing Established Ranges

29. The review of a range of depreciation rates raises essentially the same questions as those posed in our discussion of the review of basic factor ranges. Thus, we set forth the issues that should be addressed in this section:

a. While we are certain that any range we establish must be reviewed in light of technological and customer demand changes, we ask whether we should review depreciation rate ranges on a less frequent basis than we now review individual company depreciation rates. We believe that review should occur, at most, on a five to ten year cycle. <u>See</u> <u>supra</u> para. 21.

b. What procedures and methods should the Commission use to update

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[23] We note, however, that this Commission, under § 220(b) of the Communications Act, maintains final prescription authority.

depreciation rate ranges? See supra para. 22.

We invite comment on these issues.

3. Related Issues

a. Price Cap Treatment

30. As with the basic factor range option, we tentatively conclude that a depreciation rate range option will not affect the endogenous treatment accorded depreciation expense changes under price cap regulation. We base our tentative conclusion on the fact that the currently-prescribed depreciation rates incorporate companies' future investment plans, and these rates will be used to determine the range. Moreover, our proposals for updating the rate ranges will also incorporate the carriers' future investment plans. Thus, because carriers will retain control of future investment decisions, they will retain control over depreciation rate ranges, and they will further exercise control over the rate they select within the range. See supra paras. 23-24.

b. Accumulated Depreciation Imbalances

31. The depreciation rate formula we employ is a remaining-life formula because it incorporates both an accumulated depreciation and ARL for any particular account. This formula, which was adopted in 1981,[24] is an improvement over our prior rate formula because it effectively allows for the true-up of any accumulated depreciation imbalance caused by any past over or under depreciation accruals which resulted from prior over or under life and salvage estimates. Since the range rate option will not use the rate formula, it may not allow for the same true-up mechanism. Without this true-up mechanism, carriers could experience accumulated depreciation imbalances that could result in an inaccurate statement of their net book costs, and potentially in carriers not depreciating 100% of plant costs.

32. We seek comment on whether we can design a rate range approach that would incorporate a true-up mechanism. We acknowledge that designing such a mechanism under this approach may be difficult because it may be inappropriate to apply an industry-wide accumulated depreciation to specific companies. We invite comment on this issue. We specifically ask commenters to explain how we might design a true-up mechanism for this option, and how we might apply such a mechanism to individual companies.

C. The Depreciation Schedule Option

33. Under this option, the Commission would establish a depreciation schedule based on a Commission-specified average service life, retirement pattern and salvage value for each applicable plant account. The carriers would then apply the schedule for each account to their investment in that account by vintage. This option offers a greater degree of simplification than the range options and the greatest degree of depreciation expense certainty,

[24] ELG Depreciation Order, supra n. 21.

but it also offers the greatest deviation from accuracy in matching allocation of costs with plant consumption. We seek comment on the benefits and disadvantages of this trade-off, including specific quantification of administrative costs savings resulting from this option. We also invite general comment on this proposal.

1. Implementing a Depreciation Schedule Option

34. We seek comment on how we would determine the appropriate service life, retirement pattern, and salvage value for each account. One possible option would be for the Commission to establish a schedule based upon an industry-wide average of the projection life, retirement patterns, and salvage value underlying currently-prescribed rates. We invite comment on these proposals and solicit other alternatives.

35. Again, many of the same issues raised in our two range options need to be addressed here:

a. Should we develop two sets of depreciation schedules: one for LECs and another for the IXCs? We tentatively conclude that we should. <u>See supra</u> para. 15.

b. Should we adopt depreciation schedules for all accounts for which we prescribe depreciation now? We tentatively conclude that we should not. We invite comment on the appropriate criteria to determine the accounts for which we should initially establish depreciation expense schedules. <u>See supra</u> para. 16.

c. Should we mandate participation by all carriers for all accounts? This approach affords less flexibility than the range options. Thus, we do not offer a tentative conclusion on this issue. In addressing this issue, commenters should also state the appropriate waiver standard. <u>See supra</u> para. 18.

d. Should we convert all carriers to depreciation schedules at the same time? <u>See supra</u> para. 19.

We invite comment on all of these issues. Where appropriate, commenters should address any costs savings.

36. This approach raises an additional issue of whether we should apply the schedule approach to the total plant account investment for all applicable accounts or limit this approach to new plant investment. These schedules would be designed to recover 100% of plant cost over the service life in a particular account; however, some adjustments may be necessary to apply such schedules to embedded plant that already has been partially depreciated. Thus, we ask commenters to address whether applying this option on a going-forward basis only is preferable to applying it to all plant investment in any applicable account. We invite commenters to propose options that would address the transitional problems posed by embedded plant. For example, we could develop depreciation schedules for each vintage of embedded plant in a particular account, or we could aggregate all embedded plant in an account and determine a

composite depreciation schedule for that embedded plant. We seek comment on these proposals, and also invite commenters to offer alternatives.

2. Reviewing Established Depreciation Schedules

37. We seek comment on whether, and how we should review the depreciation schedules. As we explained with the range options, we are certain that review is necessary. We invite comment on how often we should review, and the procedures and methods we should employ for reviewing. Commenters should also explain what data must be maintained to conduct a review.[25]

3. Related Issues

a. Price Cap Treatment

38. We tentatively conclude that the depreciation schedule option will not affect the endogenous treatment accorded depreciation expense changes under price cap regulation. Although we recognize that this option is less flexible than the range options proposed (because it would set one schedule for each account for all carriers), we nevertheless believe that service lives, retirement patterns, and salvage underlying currently-prescribed rates incorporate companies' future investment plans, and these rates will be used to set the schedules initially and in the future. Moreover, carriers that conclude that these schedules would not be appropriate could seek a waiver of their application.

b. Accumulated Depreciation Imbalances

39. As with the range of depreciation rates option, this option also raises the issue of accumulated depreciation imbalances because it will not employ the Commission's depreciation rate formula, a remaining life formula. However, because this option ultimately provides for 100% depreciation of the costs of plant, the potential for an imbalance is merely temporary, not permanent like that which could occur under the rate range option. Thus, we seek comment on whether this temporary imbalance is a problem.

D. The Price Cap Carrier Option

40. Over the past few years, price cap carriers have argued to this Commission that, in light of the endogenous treatment of depreciation expense changes, they should not be subject to the current depreciation prescription process. These carriers posit that, because a change in depreciation expense will not generally affect rates, detailed depreciation analysis is unnecessary. Accordingly, this option focuses on whether price cap carriers should be accorded greater flexibility in the depreciation prescription process as compared to carriers that remain subject to rate of return regulation. We note

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[25] We reemphasize here that we will continue to require the carriers to maintain their continuing property records, even if we adopt a depreciation schedule approach. Accurate information on assets of the company are important to accurate maintenance of books of account.

that under the LEC price cap scheme, LECs must share earnings with their customers if earnings fall within a specified sharing zone. We seek comment on whether the sharing mechanism will have any impact on LEC depreciation decisions.

41. Under this proposal, carriers would seek depreciation rate changes by filing with this Commission the following information: their depreciation rates in effect, their proposed depreciation rates, and the changes in depreciation expense that they would experience if the proposed rates became effective. Carriers would not be required to provide supporting data for their proposed depreciation rate changes. This option would essentially eliminate all of the steps the Commission now takes to analyze the carriers proposed depreciation rates. However, these proposed depreciation rate changes would continue to be placed on Public Notice. The proposed rate changes and the comments submitted in response to the Public Notice would be reviewed to ascertain the reasonableness of the proposed changes. Ultimately, we would prescribe rates based on carriers' proposals and the comments submitted thereon. Any state commission that would be concerned with a particular carrier's filing would be notified of that carrier's proposed depreciation rate changes and invited to comment on the filing at the same time the proposed changes are placed on Public Notice. We invite comment on this option. Commenters should quantify the costs savings resulting from this option. Commenters should also address whether this option is consistent with the Commission's statutory obligation to prescribe "percentages of depreciation which shall be charged" under Section 220(b).[26] We note that this approach also would eliminate issues of implementation and review raised by the other three options.

42. We also seek comment on whether this approach would be consistent with our Section 220(i) statutory requirement. Section 220(i) states:

> The Commission, before prescribing any requirements as to accounts, records, or memoranda, shall notify each state commission having jurisdiction with respect to any carrier involved, and shall give reasonable opportunity to each such commission to present its views, and shall receive and consider such views and recommendations.[27]

It has been our practice in fulfilling this statutory requirement to have representatives from the Common Carrier Bureau, the state commissions, and the carriers to meet to discuss the various depreciation rate proposals put forth by the carriers, this Commission's staff, and any suggested by state commissions (i.e., the three-way meeting). Under this option, three-way meetings would no longer occur. Instead, we would rely on formal comments filed by a state commission in the notice and comment process. We invite comment on whether this proposal satisfies the notification requirement of Section 220(i).

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26 47 U.S.C. § 220(b).

27 47 U.S.C. § 220(i).

E. Additional Simplification: Salvage

43. The current depreciation process and the four simplification options we seek comment on include net salvage as a part of the depreciation process. In furtherance of simplification, we seek comment on whether we should, independent of those options, change our approach to salvage and not consider it in the depreciation process. This simplification option would require carriers to remove salvage from their depreciation process and require them to book the cost of removal and salvage as current period charges and credits. In addressing this proposal, commenters should quantify the effects this change would have on carriers' income statement and the administrative costs savings associated with the change. Also, we ask whether this changed treatment of salvage would be contrary to Generally Accepted Accounting Principles (GAAP).

IV. PROCEDURAL MATTERS

A. Ex Parte

44. This is a non-restricted notice and comment rulemaking proceeding. Ex Parte presentations are permitted, except during the Sunshine Agenda period, provided they are disclosed as provided in the Commission's rules.[28]

B. Regulatory Flexibility

45. We certify that the Regulatory Flexibility Act of 1980 does not apply to this rulemaking proceeding because if the proposed rule amendments are promulgated, there will not be a significant economic impact on a substantial number of small business entities, as defined by Section 601(3) of the Regulatory Flexibility Act.[29] Because of the nature of local exchange and access service, the Commission has concluded that small telephone companies are dominant in their fields of operation and therefore are not "small entities" as defined by that act.[30] The Secretary shall send a copy of this Notice of Proposed Rulemaking, including the certification, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with Section 603(a) of that act.[31]

C. Comment Dates

46. We invite comment on the proposals and tentative conclusions set forth above. Pursuant to applicable procedures set forth in Sections 1.415 and 1.419 of the Commission's Rules,[32] interested parties may file comments on or before March 10, 1993, and reply comments on or before April 13, 1993. To file formally in this proceeding, interested parties must file an original and four copies of all comments, reply comments, and supporting comments. If interested parties want each Commissioner to receive a personal copy of their comments,

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[28] See generally 47 C.F.R. §§ 1.1202, 1.1203, 1.1206(a).

[29] 5 U.S.C. §601(3).

[30] See MTS and WATS Market Structure, 93 FCC 2d 241, 338-39 (1983).

[31] 5 U.S.C. § 603(a).

[32] 47 C.F.R. §§ 1.415, 1.419.

they must file an original plus nine copies. Interested parties should send comments and reply comments to Office of the Secretary, Federal Communications Commission, Washington, D.C. 20554. Parties should also file one copy of any documents filed in this docket with the Commission's copy contractor, Downtown Copy Center, Room 640, 1990 M Street, N.W., Washington, D.C. 20036. We also ask that parties send a courtesy copy of their comments to the Accounting and Audits Division, 2000 L Street, N.W., Washington, D.C. 20554. Comments and reply comments will be available for public inspection during regular business hours in the FCC Reference Center of the Federal Communications Commission, 1919 M Street, N.W., Washington, D.C. 20554.

V. ORDERING CLAUSE

47. Accordingly, IT IS ORDERED that, pursuant to Sections 1, 4(i), 4(j), 220, and 403 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 154(i), 154(j), 220(b), and 403, NOTICE IS HEREBY GIVEN of proposed amendments to Part 43.43 of the Commission's Rules, 47 C.F.R. § 43.43 as described in this Notice of Proposed Rulemaking.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Donna R. Searcy
Secretary

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December 10, 1992

Concurring Statement
of
Commissioner Ervin S. Duggan

In Re: Simplification of the Depreciation Prescription Process: Notice of Proposed Rulemaking

While I support the Commission's decision to seek comment on various proposals for streamlining the way we prescribe depreciation rates, I have serious reservations about the notice's fourth proposal. That proposal would, in effect, eliminate all review of price cap carriers' proposed depreciation rates. To underscore my concern about this scheme, I have chosen to concur in the issuance of this notice.

I support reasonable efforts to streamline our depreciation procedures--- so long as such streamlining does not undercut the effectiveness of the depreciation prescription process. Our current approach is to approve telephone company depreciation proposals so long as the proposed rates reflect the actual rate of plant retirement. Any streamlined approach should, in my judgment, maintain the goal of accurate prescription of telephone company depreciation.

The first streamlining proposal in the Notice--- to adopt ranges for the elements that constitute the depreciation formula--- appears to me the most reasonable, particularly because it would be limited to certain accounts. I am not closed, however, to other possible approaches, and so I encourage parties to comment with care on other alternatives we have set forth in the notice.

The fourth option set forth in the notice, however, is likely to find me in opposition at the end of this rulemaking. Under that option, price cap carriers would file proposed depreciation rates with no support whatever that would justify those rates. Although the public would be allowed to comment on those proposed rates, they would do so in a vacuum. Their views would be virtually meaningless, because the carriers would have filed no documentation to support their chosen rates. This option, in effect, would mean that the FCC would simply rubber-stamp the carriers' proposed depreciation rates: Regulation by robots.

Under Section 220(b) of the Communications Act, the FCC is obliged to prescribe the percentages of depreciation that will apply to carriers' property. There are good reasons for this statutorily required close look at depreciation:

* First, depreciation is the largest component of total telephone company expense. Even a small change in depreciation rates can add up to a large change in total expenses.

* Second, depreciation expense is not a measurable out-of-pocket cost. It is, rather, an estimate of the rate at which a capital asset loses its value over time. Because of the necessarily imprecise nature of such predictions about the useful life of an asset, depreciation is susceptible to overly optimistic treatment.

* Third, many states rely upon the FCC's depreciation prescriptions (even though they are not bound to do so); and the FCC benefits from their contributions to the process.

Even for carriers under price caps, prescribing accurate depreciation rates is essential. Changes in depreciation expense may not directly affect the price cap index, but such expenses can affect the price cap indirectly if the carriers are earning enough to be in the sharing zone, where they are obliged to share excess earnings with ratepayers through future reductions in the price caps. Carriers thus have the incentive even under price caps to manipulate depreciation expenses in order to avoid the sharing obligation. The sharing mechanism, in my judgment, is a key part of the consumer protections established under the price cap plan for local telephone companies--- and should not be undermined.

Finally, the Commission needs accurate measures of depreciation expense so it can monitor the progress of price caps. If expenses are not accurately measured, it will become more difficult to assess the real level of telephone company earnings under price caps. Without accurate information, we will not be in a position to prescribe any necessary changes in the price cap formula at the time of the four-year price cap review.

For these reasons, while I support reasonable proposals for streamlining our depreciation process, I cannot support a proposal that would weaken the FCC's role in that process and threaten, ultimately, the well-being of ratepayers.

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